Application of Derivatives

Video Title: Section 3 Application of Derivatives

Last time, we introduced common types of derivatives and their natures. Now, we are going to talk about their applications. There are many applications of derivatives, but we will now focus on four applications for derivatives. They are:

(1) Speculation – Yield Enhancement;
(2) Access to Different Asset Classes;
(3) The Leverage Effect; and
(4) Long / Short Exposures & Risk Hedging.

To begin, the first application is "Speculation - Yield Enhancement". How can you use derivatives to enhance yield? Let's use a commonly available Equity-Linked Deposit as an example.

Suppose an investor has an insight. He believes the stock market will not drop significantly in the coming month, and even if certain stocks drop below a certain price, the investor is willing to buy those stocks at that price. If so, he can use the equity-linked deposit by selling a put option. If the stock price does not fall below a certain level, he can enhance his/her investment yield by receiving the option premium and he does not have to actually buy the stocks. But if the market drops, then he needs to buy the stocks at a price higher than the market price, and if the stock price falls sharply, there will be a greater risk of loss.

The second application is "Access to Different Asset Classes", meaning that you can participate in, or buy and sell, different assets (e.g. stock, foreign currency, etc.) through derivatives. By making use of derivatives, you can participate in different investment markets even in some markets that are hard to enter. As an example, the "A-share" market in mainland China is a market that participation by foreign investors is subject to restrictions; however, through what are known as Synthetic ETFs, investors can indirectly participate in the "A-share" market. These Synthetic ETFs make use of derivatives to track (or replicate) the performance of a market index as the main investment objective. Through the Synthetic ETFs, although investors cannot hold "A" shares directly, the performance of "A" shares can be reflected by the Synthetic ETFs the investors hold. This is one application of derivatives.

A third application is the "Leverage Effect". For example, you may have heard about a "warrant", which has a leveraging effect. Buying a board lot of shares in the stock market may cost tens of thousands of dollars; but if the investor chooses to buy a warrant, it may only cost a few thousand and the investors can get leveraged exposure to the shares at a lower cost. This is

called the "Leverage Effect". But, of course, by doing this, you must keep an eye on the market prices, as fluctuating prices may increase risk because you are trading derivatives, and not the stocks themselves.

Finally, the fourth application is "Long / Short Exposures & Risk Hedging". The application of derivatives has a special ability here. That is, you can buy a call warrant when you expect the market to rise or buy a put warrant when you expect the market to fall. Put warrants can help him/her to hedge against the downside risk of the market. For example, if you hold some stocks, you can buy a put warrant when you anticipate that the market will fall. If the stock price does fall, the put warrant can provide an extra yield, and compensate for some of the losses from holding the stocks.

Let's make a quick summary. Do you remember the four main applications of derivatives products? First is "Speculation - Yield Enhancement", where investors make use of Equity-Linked Deposits to increase their yield. If the stock's price does not fall below a specified level, the return to the investor will be increased because of the option premium.

Second is "Access to Different Asset Classes", which means investors can buy different products including stock or foreign currency through derivative products. Equity-Linked Deposits and Synthetic ETFs are common examples of this application

Third is the "Leverage Effect", which means investors do not need to pay tens of thousands of dollars to buy a board lot of shares, instead, they pay only a few thousand for a warrant, which can provide leveraged exposure to shares at a lower cost. This is called the "Leverage Effect".

Lastly, the fourth application is "Long / Short Exposures & Risk Hedging". Investors can buy a call warrant when they expect the market to rise or buy a put warrant when they expect the market to fall. These types of put warrants can help to hedge the downside risk of the market. Besides the applications of derivative products, we also have to understand the related risks.

The next section will explains the risk involved in derivative products.

Good bye for now!

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